GETTING FOCUSED ON ESG INVESTING

Guillermo Cano, Raina Oberoi and Raman Subramanian

October 2018
THE MSCI ESG FOCUS INDEXES

As equity investors evaluate the risk and opportunities associated with environmental, social and governance (ESG) considerations, the challenge they face is how to integrate ESG into their investment process while maintaining equity-market-like exposure. The MSCI ESG Focus Indexes are designed to help investors address this investment problem, seeking to maximize its exposure to ESG while exhibiting risk and returns similar to the underlying parent market-cap-weighted index.

TWO OBJECTIVES, ONE APPROACH: MARKET BETA + ENHANCED ESG PROFILE

Market-cap-weighted indexes have long been used as performance benchmarks and over the years have evolved into tools used to measure market beta. While a performance benchmark is broad and designed to represent the entire investable opportunity set, is it possible to create an ESG-oriented index with risk and return characteristics similar to those of an underlying market-cap-weighted index? To answer this question, we compare ESG Focus Indexes in two key markets, the U.S. and EAFE, to their underlying parent indexes.

The MSCI USA ESG Focus Index and the MSCI EAFE ESG Focus Index are constructed using the constituents of the market-cap-weighted MSCI USA Index and MSCI EAFE Index, respectively, as starting universes. Stocks involved in tobacco and controversial weapons, commonly viewed by investors as engaging in controversial activities, are excluded from the ESG Focus Indexes. Once these stocks are removed, the index is optimized to maximize the ESG score while maintaining replicability and broad diversification at the country, sector and stock level. Depending on country or region, each ESG Focus Index has a targeted tracking error between 0.50% and 1.00%. Tracking error describes the degree to which a portfolio’s performance deviates from the parent index. By keeping the tracking error within a narrow range, the ESG Focus Indexes work to maintain market-like characteristics while improving their ESG profiles.

1 ESG scores range from 0-10 and are derived from the MSCI ESG Ratings framework, which rates companies according to their exposure to industry-specific ESG risks and their ability to manage those risks relative to peers. The MSCI ESG Rating indicates how well a company manages environmental, social, and governance risks relative to industry peers.

2 Please refer to Appendix 1: Tobacco and Controversial Weapons Exclusion Criteria of the MSCI ESG Focus Index Methodology for further detail.

3 Similar risk and return characteristics and an improved ESG profile were observed for the MSCI EM (Emerging Markets) ESG Focus Index over the same period from November 2010 to August 2018.
MSCI ESG FOCUS INDEXES VS. THEIR MARKET-CAP-WEIGHTED PARENT INDEXES

As we can see in the exhibits below, the ESG Focus Indexes generated similar levels of risk and return compared to their corresponding parent indexes, from November 2010 to August 2018, each with a tracking error of 0.60% and market beta of approximately 1.0, implying that over time the portfolios moved in line with the market. The factor exposures of each ESG Focus Index were similar to the parent indexes as well.

| Risk and return of MSCI ESG Focus Indexes vs. their market-cap-weighted parent |
|--------------------------------------|------------------|------------------|------------------|------------------|
| MSCI USA Index | MSCI USA ESG Focus Index | MSCI EAFE Index | MSCI EAFE ESG Focus Index |
| Total Return (%) | 14.6 | 14.6 | 6.7 | 7.1 |
| Total Risk (%) | 10.8 | 10.8 | 13.6 | 13.7 |
| Return/Risk | 1.35 | 1.35 | 0.49 | 0.52 |
| Sharpe Ratio | 1.30 | 1.31 | 0.46 | 0.48 |
| Active Return (%) | 0.0 | 0.1 | 0.0 | 0.3 |
| Tracking Error (%) | 0.0 | 0.6 | 0.0 | 0.6 |
| Information Ratio | NaN | 0.16 | NaN | 0.56 |
| Historical Beta | 1.00 | 1.00 | 1.00 | 1.01 |
| No of Stocks | 615 | 319 | 922 | 417 |
| Turnover (%) | 1.7 | 16.5 | 1.8 | 21.6 |

Annualized Returns for Nov. 30, 2010 to Aug. 31, 2018
Looking deeper into the portfolios, on average, the MSCI USA ESG Focus Index and the MSCI EAFE ESG Focus Index contained 319 and 416 stocks, respectively, which equaled approximately 50% of the stocks held in their parent indexes. Nonetheless, on a historical basis, both ESG Focus Indexes had sector exposures comparable to those of their parent indexes, as seen in the exhibit below. This implies that the ESG Focus Indexes did not take significant sector bets relative to the underlying market.⁴

⁴ Please note that the changes to the GICS® structure, including the change in name from the Telecommunications Services Sector to the Communication Services Sector will be applied to MSCI Equity Indexes as part of the November 2018 Semi-Annual Index Review. GICS® is the global industry classification standard jointly developed by MSCI and Standard & Poor’s.
Even though the ESG Focus Indexes maintained similar market-like profiles, they both improved ESG profiles by approximately 20%. As of Aug. 31, 2018, the average MSCI ESG Rating for the MSCI USA ESG Focus Index was 6.5 compared to 5.4 for the MSCI USA Index, and the MSCI EAFE ESG Focus Index averaged 7.7 compared to 6.6 for the MSCI EAFE Index. Over the period from December 2013 through May 2018, both ESG Focus Indexes consistently achieved average ESG scores well in excess of their parent indexes.

Historical ESG Scores for the MSCI EAFE, and the MSCI USA Indexes over the period from December 2013 to May 2018
When compared to their corresponding market-cap-weighted indexes, both ESG Focus Indexes included roughly double the weight from ESG Leaders (stocks rated AA to AAA) and significantly lower weight from ESG Laggards (stocks rated CCC to B). Additionally, as stated earlier, the ESG Focus Indexes excluded stocks involved in tobacco and controversial weapons.

The MSCI USA ESG Focus Index and the MSCI EAFE Focus Index are designed to balance equity investors’ desire for an improved ESG profile while maintaining exposure to the equity market in order to seek the full equity premium. Optimizing the portfolio construction of the MSCI ESG Focus Indexes resulted in reduced tracking error and helped limit the differences in return between the indexes and their parent market-cap-weighted indexes.

---

5 Stocks rated AA to AAA are equivalent to ESG score ratings of 7.1 – 10.0 and stocks rated B to CCC are equivalent to ESG score ratings of 0.0 to 2.9.

6 MSCI has also developed the MSCI Extended ESG Focus Indexes, which exclude tobacco and controversial weapons companies, as well as those that produce or have ties with civilian firearms.
ABOUT MSCI
For more than 40 years, MSCI’s research-based indexes and analytics have helped the world’s leading investors build and manage better portfolios. Clients rely on our offerings for deeper insights into the drivers of performance and risk in their portfolios, broad asset class coverage and innovative research.

Our line of products and services includes indexes, analytical models, data, real estate benchmarks and ESG research.

MSCI serves 99 of the top 100 largest money managers, according to the most recent P&I ranking.

For more information, visit us at www.msci.com.
This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the “Information”) is the property of MSCI Inc. or its subsidiaries (collectively, “MSCI”), or MSCI’s licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the “Information Providers”) and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or redisseminated in whole or in part without prior written permission from MSCI.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, “Index Linked Investments”). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investible assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

 Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on www.msci.com.

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.’s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.’s company filings on the Investor Relations section of www.msci.com.

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Except with respect to any applicable products or services from MSCI ESG Research, neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI’s products or services are not intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Issuers mentioned or included in any MSCI ESG Research materials may include MSCI Inc., clients of MSCI or suppliers to MSCI, and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD, and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and Standard & Poor’s. “Global Industry Classification Standard (GICS)” is a service mark of MSCI and Standard & Poor’s.